SDCERS
San Diego City Employees' Retirement System

David B. Wescoe
Administrator/CEO

RECEIVED
OCT 29 2007
COUNCILMEMBER
DONNA FRYE

October 29, 2007

Councilmember Donna Frye
The City of San Diego
202 C Street, MS 10A
San Diego, CA 92101

Subject: Your October 8, 2007 Request for IRS Documents

Dear Councilmember Frye:

On October 8, you requested a copy of "written authority from the IRS supporting the legality" of the DROP program and copies of any IRS and/or outside attorney regarding the "establishment, funding, and tax exempt or non-tax exempt status of the DROP program, contributions thereto or distributions therefrom."

With respect to the legality of the City's DROP program, your request is probably more appropriately addressed to the City's lawyers, not SDCERS. SDCERS has not applied for an IRS opinion regarding the legality of the City's DROP program, nor is DROP's legality at issue in our ongoing VCP process. We are not aware of any IRS opinion questioning the legality of DROP programs in general.

I have enclosed several DROP-related legal opinions that have been provided to other retirement systems that you might find of interest.

Please call me if you have any questions.

Sincerely,

David B. Wescoe

Enclosures

Significant Index Nos. 0401.00-00, 0402.00-00, 0414.00-00, 0415.00-00

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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RECEIVED

OCT 2 9 2007

COUNCILMEMBER
DONNA FRYE

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

FEB 2 6 2007

Re:

DROP =

State =

Dear

This letter is in response to your request for a ruling concerning the Plan which was submitted by your authorized representative on May 5, 2006, as amended on February 6, 2007, concerning the DROP under the Plan. Specifically, you asked us to rule on the following issues:

(1) The DROP is not a separate defined contribution plan.

(2) The limitation for defined benefit plans under section 415(b) of the Internal Revenue Code ("Code") applies to the DROP rather than the limitation for defined contribution plans under section 415(c) of the Code, and the annuity equivalent of the DROP single sum plus the normal annuity benefit under the Plan will be tested for purposes of section 415(b).

(3) The DROP complies with the definitely determinable requirement of section 401(a) of the Code.

(4) The mere fact that Participant contributions that are already being picked-up under the Plan pursuant to section 414(h)(2) of the Code will continued unchanged during participation in the DROP will not result in said contributions being ineligible for pick-up.

(5) Credits to a participant's DROP account are not distributions from the Plan and are not subject to current income taxes or to the additional 10% tax on early distributions under section 72(t) of the Code.

(6) Single sum distributions from a participant's DROP account will be eligible for rollover under section 402(c)(4) of the Code.

The System is an instrumentality of political subdivisions of the State and was established under chapter 411 of the Code of the State ("State Code"). The Plan is a governmental plan within the meaning of section 414(d) of the Code[1] and a defined benefit plan under section 414(j) of the Code. The System provides pension benefits to its participants, who are police officers and firefighters employed by participation political subdivisions of the State. There are approximately 3800 active participants in the System. Participation in the Plan is required as a condition of employment. Cities whose police officers and/or firefighters are appointed under the civil service law of the State are generally required to participate in the System. The Plan received a favorable determination letter regarding its qualified status under section 401(a) of the Code in a letter dated November 22, 1994.

Section 411.1 of the State Code describes the various definition of terms used in the Plan in determining retirement benefits.

Section 411.1(1) defines "actuarial equivalent"as a benefit of equal value when computed upon the basis of mortality tables adopted by the Plan and interest computed at the rate established by the System's actuary.

Section 411.1(3) defines "average final compensation" as the average earnable compensation of the member during the three years of service the member earned the member's highest salary as a police officer or firefighter, or if the member has less than three years of service, the average earnable compensation of the member's entire period of service.

Section 411.1(7) defines "city" as any city participating in the statewide fire and police retirement system.

Section 411.1(8) defines "earnable compensation" as the annual compensation which a member receives for service rendered as a police officer or firefighter in the course of employment with a participating city. However, the term shall not include amounts received for overtime compensation, meal or travel expenses, uniform allowances, fringe benefits, severance pay, or any amount received upon termination or retirement in payment for accumulated sick leave or vacation. Contributions made by a member from the member's earnable compensation to a plan of deferred compensation shall be included in this term.

Section 411.1(9) defines " firefighter" as only the members of a fire department who have passed a regular mental and physical civil service examination for firefighters and who shall have been duly appointed to such a position.

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[1] We are accepting the Taxpayer's representation that it is a governmental plan within the meaning of section 414(d) of the Code. We have neither analyzed this issue, nor are we ruling on this issue.

Section 411.1(11) defines "member" as a member of the System as defined by section 411.3 of the State Code.

Section 411.1(13) defines "membership service" as service as a police officer or firefighter rendered for a city which is credited for service pursuant to section 411.4 of the State Code.

Section 411.1(15) defines "pension" as the annual payments for life derived from appropriations provided by the participating cities and the state and from contributions of the members which are deposited in the System. All pensions shall be paid in equal monthly installments.

Section 411.1(16) defines "police officer" as only members of a police department who have passed a regular mental and physical civil service examination and who shall have been duly appointed to such positions.

Section 411.1(17) defines "retirement allowance" as the pension granted to a member upon retirement.

Section 411.3 of the State Code states that all persons who become police officers or firefighters after the date the city is required to come under the retirement system shall become members of the Plan as a condition of employment.

Section 411.4 of the State Code states that service of fewer than six months of a year is not creditable as service. Service of six months or more of a year is equivalent to one year of service.

Section 411.6 of the State Code describes benefits under the Plan. Section 411.6(1) states that any member in service may retire upon written application to the System setting forth a date of retirement not less than thirty days but not more than ninety days from the date of the application. However, the member must have attained age fifty-five and have served twenty-two years or more upon the selected date of retirement.

Section 411.6(2)(a) states that the service retirement allowance for a member who terminates service, other than by death or disability, prior to July 1, 1990, shall consist of a pension which equals fifty percent of the member's average final compensation.

Section 411.6(2)(b) states that the service retirement allowance for a member who terminates service, other than by death or disability, on or after July 1, 1990, but prior to July 1, 1992, shall consist of a pension which equals fifty-four percent of the member's average final compensation.

Section 411.6(2)(c) states that commencing July 1, 1992, for members who terminate service other than by death or disability, on or after that date but prior to July 1, 2000, the System shall increase the percentage multiplier of each member's average final compensation by an additional two percent each July 1 until reaching sixty percent of the member's average final compensation. The applicable percentage multiplier shall be the rate in effect on the date of the member's termination from service.

Section 411.6(2)(d) states that upon retirement from service on or after July 1, 2000, a member shall receive a service retirement allowance which will consist of a pension which equals sixty-six percent of the member's average final compensation.

Section 411.6(2)(e) sets forth an additional benefit for members with more than 22 years of service. If a member has completed more than 22 years of creditable service, the service retirement allowance shall consist of a pension which equals the amounts provided in section 411.6(2)(a), (b), (c), or (d), plus an additional percentage set forth below:

(1) For a member who terminates service other than by death or disability on or after July 1, 1990, but before July 1, 1991, and who does not withdraw the members contributions, upon the member's retirement there shall be added three-tenths percent of the member's average final compensation for each year of service over twenty-two years, excluding years of service after the member's fifty-fifth birthday, but not more than eight years of service.

(2) For a member who terminates service other than by death or disability on or after July 1, 1991, but before October 16, 1992, and who does not withdraw the members contributions, upon the member's retirement there shall be added six-tenths percent of the member's average final compensation for each year of service over twenty-two years, excluding years of service after the member's fifty-fifth birthday, but not more than eight years of service.

(3) For a member who terminates service other than by death or disability on or after October 16, 1992, but before July 1, 1998, and who does not withdraw the members contributions, upon the member's retirement there shall be added six-tenths percent of the member's average final compensation for each year of service over twenty-two years, but not more than eight years of service.

(4) For a member who terminates service other than by death or disability on or after July 1, 1998, but before July 1, 2000, and who does not withdraw the members contributions, upon the member's retirement there shall be added one and one-half percent of the member's average final compensation for each year of service over twenty-two years, but not more than eight years of service.

(5) For a member who terminates service other than by death or disability on or after July 1, 2000, and who does not withdraw the members contributions, upon the member's retirement there shall be added two percent of the member's average final compensation for each year of service over twenty-two years, but not more than eight years of service.

Section 411.6(12) provides for an annual readjustment, similar to a cost-of-living increase, to the pension.

Section 411.6A provides optional forms of benefit under the Plan.

Section 411.6B of the State Code provides for the rollover of a member's accrued benefit to an eligible retirement plan.

The State legislature amended chapter 411 of the State Code in 2006 to add the DROP as a distribution option under the System. The DROP is codified as section 411.6C of the State Code. The legislature conditioned implementation of the DROP on the receipt of favorable ruling from the Service.

Section 411.6C(1)(a) defines "applicable percentage" as the percentage, not greater than one hundred percentage points, equal to fifty-two percentage points plus two percentage points for each month for the period between the eligible member's plan eligibility month and the month the eligible member commences membership in the DROP.

Section 411.6C(1)(b) defines "DROP benefit" as an amount credited to the participant's account each applicable month equal to the member's applicable percentage multiplied by the member's participant retirement amount.

Section 411.6C(1)(c) defines "eligible member" as a member who has attained fifty-five ears of age with at least twenty-two years of membership service.

Section 411.6C(1)(d) defines "participant account" as the administrative record maintained by the System reflecting the participant's accumulated DROP benefit.

Section 411.6C(1)(e) defines "participant retirement amount" as the amount equal to the monthly retirement allowance the eligible member would have received under section 411.6 of the State Code if the member retired on the date the eligible member commenced participation in the DROP, based on earnings through the previous full quarter of earnable compensation earned by the member.

Section 411.6C(1)(g) defines "plan eligibility month" as the first full calendar month in which the participant is an eligible member.

Section 411.6C(2)(a) states that an eligible member may elect to participate in the DROP. A decision by an eligible member to participate in the DROP is irrevocable. Upon commencing membership in the DROP, the member shall remain an active member in the System and shall have credited to a participant account on behalf of the member the DROP benefit for each month the member participates in the DROP. The amounts credited will be invested by the System in risk-free assets of a short-term nature and interest and earnings shall not be credited to the member's participant account but remain in the System. The annual readjustment to pensions under section 411.6(12) of the State Code shall not apply to the participant's DROP benefit or to amounts credited to the member' participant account.

Section 411.6C(2)(b) states that upon termination of an eligible member's participation in the DROP, the eligible member shall be deemed to be retired under the System as of that date for purposes of the System and shall begin receiving a retirement allowance equal to the member's participant retirement amount or such optional retirement benefits based upon that amount pursuant to section 411.6A of the State Code. In addition, the eligible member shall receive the moneys credited to the member's participant account while participating in the DROP. The eligible member shall select whether to receive the amount in the member's participant account in the form of a single sum distribution or as a rollover to an eligible retirement plan as defined in section 411.6B of the State Code.

Section 411.6C(2)(c) states that if an eligible member terminates participation in the DROP prior to the date selected by the member upon commencing membership in the DROP ad the termination is not due to the death or disability of the member, then the System shall assess a twenty-five percent penalty on the amount credited to the member's participant account prior to distributing the amount to the member. The penalty amount shall be transferred to and remain with the System. The administrative rules implementing this section provided that an amount equal to seventy-five percent of the member's DROP benefit shall accrue to the benefit of the member for each month of participation in the DROP and that an amount equal to twenty-five percent of the member's accumulated DROP benefit shall accrue to the benefit of the member upon the occurrence of any of the following events: (1) termination of participation in the DROP on the selected plan termination date; (2) termination of participation prior to the selected DROP termination date as the result of entitlement to a disability benefit under either section 411.6(3) or section 411.6(5) of the State Code; or (3) death prior to the selected DROP termination date.

Section 411.6C(3) provides that to participate in the DROP, the eligible member must make written application to the System. The application shall include the following:

a. The month the eligible member intends to commence participation in the DROP.
b. The eligible member's selection of a DROP termination date. The DROP termination date shall be either three, four, or five years after the date the eligible member commences membership in the DROP. However, for the two-year period beginning with the first of the month following the implementation date of the DROP, an eligible member between sixty-two and sixty-four years of age may also select a plan termination date that is one or two years after the date the eligible member commences participation in the DROP.

Section 411.6C(5) provides that the members' contribution rate shall be increased as necessary if the DROP has been determined by the System's actuary to increase the actuarial cost to the System.

Section 411.6C(6) provides that the DROP will not be implemented until the System has received a favorable ruling from the Service.

Section 411.8 of the State Code describes the financing of the Plan. Section 411.8(g) provides for mandatory member contributions to the Plan. Section 411.8(f) and (h) specify the percentages of these mandatory contributions.

Section 411.8(i)(1) provides that beginning January 1, 1995, for federal income tax purposes, and beginning January 1, 1999, for state income tax purposes, member contributions to the Plan required under section 411.8(f) or (h) which are picked up by the city shall be considered employer contributions for federal and state income tax purposes., and each city shall pick up the member contributions to be made under section 411.8(f)(or (h) by its employees. Each city shall pick up these contributions by reducing the salary of each of its covered employees by the amount which each employee is required to contribute under section 411.8(f) or (h) and shall pay the amount picked up in lieu of the member contributions to the board of trustees.

Section 411.8(i)(2) provides that member contributions picked up by each city under section 411.8(1) shall be treated as employer contributions for federal and state income tax purposes only and for all other purposes shall be treated as employee contributions and deemed part of the employee's earnable compensation or salary.

Section 72(a) of the Code provides that gross income includes any amounts received as an annuity under an annuity, endowment, or life insurance contract.

Section 72(t) of the Code imposes a 10 percent additional tax on early distributions from qualified retirement plans.

Section 401(a) of the Code provides the requirements for a qualified pension plan.

Section 401(a)(25) of the Code provides that a defined benefit pension plan shall not be treated as providing definitely determinable benefits unless, whenever the amount of any benefit is to be determined on the basis of actuarial assumptions, such assumptions are specified in the plan in a way which precludes employer discretion.

Section 401(a)(31)(A) of the Code provides that a trust shall constitute a section 401(a) qualified trust only if the plan of which such trust is a part provides that if the distributee of any eligible rollover distribution (i) elects to have such distribution paid directly to an eligible retirement plan, and (ii) specifies such eligible retirement plan to which such distribution is to be paid (in such form and at such time as the plan administrator may prescribe), such distribution shall be in the form of a direct trustee-to-trustee transfer to the eligible retirement plan so specified.

Section 402(a) of the Code provides that any amount actually distributed to a distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year in which distributed, under section 72 (related to annuities).

Section 402(c)(4) of the Code provides that the term "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust except the following distributions: (A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made (i) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (ii) for a period of 10 years or more; (B) any distribution to the extent the distribution is required under section 401(a)(9); and (C) any distribution which is made upon hardship of an employee.

Section 414(d) of the Code provides, in part, that the term "governmental plan" means a plan established and maintained for its employees by a State or political subdivision thereof.

Section 414(h)(1) of the Code provides in general that amounts contributed to a plan qualified under section 401(a) shall not be treated as having been made by the employer if they are designated as employee contributions. Section 414(h)(2) provides an exception to section 414(h)(1) in the case of any plan established by the government of a State or political subdivision thereof where the contributions or employees of an employing unit are picked up by the employing unit. In that case, the contributions so picked up shall be treated as employer contributions.

Section 414(i) of the Code provides that the term "defined contribution plan" means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

Section 414(j) of the Code provides that the term "defined benefit plan" is any plan that is not a defined contribution plan.

Section 414(k) provides that a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant shall:

(1) for purposes of section 410 (relating to minimum participation standards), be treated as a defined contribution plan,

(2) for purposes of sections 72(d) (relating to treatment of employee contributions as separate contract), 411(a)(7)(A) (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 401(m) (relating to nondiscrimination tests for matching requirements and employee contributions), be treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan, and
(3) for purposes of section 4975 (relating to tax on prohibited transactions), be treated as a defined benefit plan.

Section 415 of the Code provides for certain limitations on contributions and benefits under qualified plans. Section 415(c) of the Code limits the annual additions to which a participant may be entitled under a defined contribution plan during any limitation year.

Section 415(b) of the Code limits the annual benefit to which a participant may be entitled under a defined benefit pension plan during any limitation year. Section 415(b)(1) provides that, in general, benefits with respect to a participant exceed the limitation if such annual benefit is greater than the lesser of (A) $160,000 or (B) 100 percent of the participant's average compensation for the participant's high 3 years.

Section 415(b)(2)(A) of the Code provides that, in general, the term annual benefit for purposes of section 415(b)(1) means a benefit payable annually as a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions are made.

Section 415(b)(2)(B) of the Code provides that if the benefit under the plan is payable in any form other than the form described in section 415(b)(2)(A), or if the employees contribute to the plan or make rollover contributions, the determinations as to whether the limitation described in section 415(b)(1) has been satisfied shall be made in accordance with regulations prescribed by the Secretary of the Treasury, by adjusting such benefit so that it is equivalent to the benefit described in section 415(b)(2)(A).

Section 415(c)(1) provides that, in general, contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an annual addition (within the meaning of paragraph (2)) to the participant's account, such annual addition is greater than the lesser of (A) $40,000, or (B) 100 percent of the participant's compensation.

Section 415(c)(2) of the Code provides that for purposes of paragraph (1), the term "annual addition" means the sum for any year of (A) employer contributions, (B) the employee contributions, and (C) forfeitures. For the purposes of this paragraph, employee contributions under subparagraph (B) are determined without regard to any rollover contributions (as defined in sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and

457(e)(16)) without regard to employee contributions to a simplified employee pension which are excludable from gross income under section 408(k)(6). Subparagraph (B) of paragraph (1) shall not apply to any contribution for medical benefits (within the meaning of section 419A(f)(2)) after separation from service which is treated as an annual addition.

Section 1.401-1(b)(1)(i) of the regulations provides that a pension plan within the meaning of Code section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Retirement benefits are generally measured by, and based on, such factors as years of service and compensation received by employees. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of Code section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits.

Section 1.401(a)(31)-1, Q&A-1, of the regulations provides that for purposes of section 401(a)(31) of the Code, eligible rollover distribution has the meaning set forth in section 402(c)(4) of the Code and section 1.402(c)-2 of the regulations.

Section 1.402(c)-2, Q&A-3(a), of the regulations provides that, unless specifically excluded, an eligible rollover distribution means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan.

Section 1.402(c)-2, Q&A-3(b), of the regulations provides that an eligible rollover distribution does not include the following:

(1) Any distribution that is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods--(i) the life of the employee (or the joint lives of the employee and the employee's designated beneficiary); (ii) the life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary); or (iii) a specified period of ten years or more;
(2) Any distribution to the extent the distribution is a required minimum distribution under section 402(a)(9) of the Code; or
(3) The portion of any distribution that is not includible in gross income.

Section 1.402(c)-2, Q&A-4, of the regulations provides that an eligible rollove distribution does not include the following:

(1) Elective deferrals, as defined in section 402(g)(3), that, pursuant to § 1.415-6(b)(6)(iv), are returned as a result of the application of the section 415 limitations, together with the income allocable to these corrective distributions.

(2) Corrective distributions of excess deferrals as described in § 1.402(g)-1(e)(3), together with the income allocable to these corrective distributions.
(3) Corrective distributions of excess contributions under a qualified cash or deferred arrangement described in § 1.401(k)-2(b)(2) and excess aggregate contributions described in § 1.401(m)-2(b)(2), together with the income allocable to these distributions.
(4) Loans that are treated as deemed distributions pursuant to section 72(p).
(5) Dividends paid on employer securities as described in section 404(k).
(6) The costs of life insurance coverage (P.S. 58 costs).
(7) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin.

Section 1.402(c)-2, Q&A-6(a), of the regulations provides that a payment is treated as independent of the payments in a series of substantially equal payments, and thus not part of the series, if the payment is substantially larger or smaller than the other payments in the series. An independent payment is an eligible rollover distribution if it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the payment is made before, with, or after payments in the series. For example, if an employee elects a single payment of half of the account balance with the remainder of the account balance paid over the life expectancy of the distributee, the single payment is treated as independent of the payments in the series and is an eligible rollover distribution unless otherwise excepted.

Section 1.415-3(a)(1) of the regulations provides that the annual benefit to which a participant is entitled at any time under a defined benefit plan may not during the limitation year exceed the dollar and compensation limitations of section 412(b)(1) of the Code. Section 1.415-3(c)(1) provides the rules concerning the adjustment of the limitations of section 415(b)(1) of the Code where the form of benefit is other than a straight life annuity.

Rev. Rul. 69-427, 1969-2 C.B. 87, provides that benefits are not definitely determinable if such benefits are contingent upon the amount of actual employer contributions to the plan.

Rev. Rul. 72-97, 1972-1 C.B. 106, provides that pre-retirement death benefits are not definitely determinable if such benefits are based on the amount of pension benefits funded at each participant's death.

Rev. Rul. 74-385, 1974-2 C.B. 130, provides that, in the case of a defined benefit plan, the definitely determinable requirement of section 1.401(b)(1)(i) of the Regulations is satisfied where the benefits for each participant can be computed in accordance with an express formula contained in the plan that is not subject to the discretion of the employer.

Rev. Rul. 79-90, 1979-1 C.B. 155, provides that whenever the amount of a benefit in a defined benefit plan is to be determined by some procedure (such as "actuarial equivalent", "actuarial reserve", or "actuarial reduction") which require the use of actuarial assumptions (interest, mortality, etc.) the assumptions to be used must be specified within the plan in a manner which precludes employer discretion. For the purposes of that revenue ruling, employer discretion includes discretion of the employer, plan administrator, fiduciary, actuary, etc.

Rev. Rul. 2006-43, 2006-35 I.R.B. 329, provides what actions are required in order for a State or political subdivision thereof, or an agency or instrumentality of any of the foregoing, to "pick up" employee contributions to a plan qualified under section 401(a) of the Code so that the contributions are treated as employer contributions pursuant to section 414(h)(2). Under the authority of section 7805(b)(8) of the Code, the Service will not treat any plan that on or before August 28, 2006, includes designated employee contributions that were intended to be picked up as employer contributions pursuant to section 414(h)(2) as failing to meet the requirements of such section prior to January 1, 2009, solely on account of the failure to satisfy the requirement that the "pick-up" be pursuant to a formal action, by a person duly authorized to take such action with respect to the employing unit, that is evidenced by contemporaneous writing, but only if the following conditions are satisfied: (1) the employing unit has taken contemporaneous action evidencing an intent to establish a "pick-up" (e.g., provided information to employees relating to the establishment of the "pick-up") and has operated the plan accordingly; and (2) the employing unit takes formal action in writing prior to January 1, 2009, with respect to future contributions to specify that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively and be evidenced by a contemporaneous written document (e.g., minutes of a meeting, a resolution, or an ordinance).meet the requirements set forth above in paragraph (1) of Law and Analysis in the revenue ruling.

Issue 1

Under the terms of the Plan, a police officer or firefighter who has reached the age of 55 and has 22 years of creditable service is eligible for a retirement allowance. Such police officer or firefighter is also eligible to participate in the DROP at the same time. If the eligible member elects to participate in the DROP, the member remains an active member in the System. However, his retirement allowance is then "frozen" as of the date of participation in the DROP, and this frozen retirement allowance becomes the participant's retirement amount. After participation in the DROP commences, a DROP benefit equal to the member's applicable percentage multiplied by the member's participant retirement amount shall have credited to a participant account on behalf of the member the DROP benefit for each month the member participates in the DROP. The amounts credited will be invested by the System in risk-free assets of a short-term nature and interest and earnings on such amounts shall not be credited to the member's participant account but remain in the System. The annual readjustment to pensions under section 411.6(12) of the State Code shall not apply to the participant's DROP benefit or to amounts credited to the member' participant account.

Section 414(i) of the Code provides that the term "defined contribution plan" means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account. Where the amounts placed in an account for a participant do not receive their share of the actual earnings and losses of the plan, the account is not an individual account within the meaning of section 414(i). The DROP benefit is based solely on the amounts contributed to the participant's DROP account, which is not adjusted for income, expenses, and gains and losses of the invested assets. Accordingly, the Plan, after the DROP amendment, is a not a separate defined contribution plan. The Plan is also not a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant as described in section 414(k) of the Code.

Issue 2

Under section 411.6C(2)(b) of the State Code, upon termination of an eligible member's participation in the DROP, the eligible member shall be deemed to be retired under the System as of that date for purposes of the System and shall begin receiving a retirement allowance equal to the member's participant retirement amount or such optional retirement benefits based upon that amount pursuant to section 411.6A of the State Code. In addition, the eligible member shall receive the moneys credited to the member's participant account while participating in the DROP. The eligible member shall select whether to receive the amount in the member's participant account in the form of a single sum distribution or as a rollover to an eligible retirement plan as defined in section 411.6B of the State Code.

Hence, the DROP benefit under the Plan allows a participant to elect an optional form of benefit which provides for a retirement allowance from the Plan and a separate payment from the DROP. Since the Plan, after the DROP amendment, is a defined benefit plan that does not provide any benefits based partly on the balance of a separate account for a participant, the limitation on annual benefits under section 415(b) of the Code applies to the entire benefit under the Plan. Furthermore, for purposes of testing whether the member's benefit exceeds the limitation under section 415(b)(1) of the Code, the annuity equivalent of the DROP single sum plus the normal annuity benefit under the Plan will be tested for purposes of section 415(b).

Issue 3

Once a member under the Plan has attained age 55 and 22 years of service, the member is eligible to elect to participate in the DROP under section 411.6C(2)(a) of the State Code. If a member elects to participate in the DROP, the member receives a participant retirement amount and a DROP payment. The calculation of the DROP payment is described above. The calculation of the DROP payment does not include interest, and the DROP payment is never placed in a separate account.

Section 411.6C of the State Code clearly defines the calculation of the participant retirement allowance and DROP payment for each member in accordance with an express formula that is not subject to employer discretion. The benefit under the DROP is not contingent upon the amount of actual employer contributions to the Plan. The benefit under the DROP is also not based on the amount of pension benefits funded at each member's retirement date. Furthermore, section 411.8 defines the actuarial assumptions used for calculating actuarial equivalent benefits under the Plan in accordance with section 401(a)(25) of the Code and Rev. Rul. 79-90.

Because the benefit under the DROP is based on a member's service and compensation, and upon contributions paid by the member while he participated in the Plan, is not contingent upon the amount of actual employer contributions to the Plan, is not based on the amount of pension benefits funded at each member's retirement date, and the employer and employee contributions under the Plan can be determined actuarially by projecting service and compensation to an assumed retirement age, the Plan with the DROP meets the definitely determinable requirement for pension plans under section 1.401-1(b)(1)(i) of the Income Tax Regulations.

Issue 4

Section 411.8(i)(1) of the State Code provides that beginning January 1, 1995, for federal income tax purposes, and beginning January 1, 1999, for state income tax purposes, member contributions to the Plan required under section 411.8(f) or (h) which are picked up by the city shall be considered employer contributions for federal and state income tax purposes., and each city shall pick up the member contributions to be made under section 411.8(f) or (h) by its employees.

Section 411.8(i)(2) provides that member contributions picked up by each city under section 411.8(1) shall be treated as employer contributions for federal and state income tax purposes only and for all other purposes shall be treated as employee contributions and deemed part of the employee's earnable compensation or salary.

Rev. Rul. 2006-43, 2006-35 I.R.B. 329, provides what actions are required in order for a State or political subdivision thereof, or an agency or instrumentality of any of the foregoing, to "pick up" employee contributions to a plan qualified under section 401(a) of the Code so that the contributions are treated as employer contributions pursuant to section 414(h)(2). Generally, any plan that includes designated employee contributions that were intended to be picked up as employer contributions pursuant to section 414(h)(2) will meet the requirements of such section if the following conditions are satisfied: (1) the employing unit has taken contemporaneous action evidencing an intent to establish a "pick-up" (e.g., provided information to employees relating to the establishment of the "pick-up") and has operated the plan accordingly; and (2) the employing unit takes formal action in writing with respect to future contributions to specify that the contributions, although designated as employee contributions, are being paid by the employer.

The Plan meets the conditions of Rev. Rul. 2006-43 because the State Code clearly spells out an intent to establish a "pick up" and the Plan has been operated accordingly, and the provision does not permit a participating employee to have a cash or deferred election with regard to the designated employee contributions.

After the DROP is adopted, participant contributions for participants in the DROP will continue at the same rates as spelled out in section 411.8 of the State Code and these provisions apply equally to participants who participate in the DROP and those that do not. Furthermore, DROP participant contributions will be credited to System assets and not participant accounts. Hence, the mere fact that Participant contributions that are already being picked-up under the Plan pursuant to section 414(h)(2) of the Code will continue unchanged during participation in the DROP will not result in said contributions being ineligible for pick-up.

Issue 5

Under section 411.6C(1)(b), the DROP benefit is credited to the participant's account during the participation period. Such amounts are held in the System and remain assets of the System. No part of the DROP benefit is distributed to a member until the member terminates participation in the DROP. Accordingly, the crediting of the DROP benefit to the participant's account is not a plan distribution to the member from the Plan. Hence, the DROP benefit is neither subject to tax under section 402(a) of the Code nor the 10 percent additional tax under section 72(t) of the Code prior to the time when an actual distribution takes place.

Issue 6

Section 411.6B of the State Code provides for the eligible rollover of distributions from the Plan to another eligible retirement plan in accordance with section 401(a)(31) of the Code.

As already discussed above, the benefit under the DROP allows the member to elect an optional form of benefit which provides for a participant retirement amount and DROP payment. Under section 411.6C(2)(b), upon termination of participation in the DROP, the distribution of the DROP payment must be either in the form of a single sum distribution or as a rollover to an eligible retirement plan as described in section 411.6B.

The DROP payment is independent of the participant retirement amount and is substantially larger than the monthly participant retirement amount. Hence, in accordance with section 1.402(c)-2, Q&A-6(a), of the regulations, the DROP payment is treated as independent of the monthly participant retirement amount payments (which are a series of substantially equal payments) and thus not part of the series of monthly participant retirement amount payments, because the DROP payment is substantially larger than the monthly participant retirement amount payments. Since the DROP payment is an independent payment, it is, in accordance with this same section of the regulations, an eligible rollover distribution if it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the DROP payment is made before, with, or after the monthly annuity payments commence.

Furthermore, the DROP payment is not a distribution required under section 401(a)(9) of the Code, made upon the participant's hardship, or otherwise excluded from the term "eligible rollover distributions" by section 402(c)(4) of the Code or section 1.402(c)-2 of the Regulations. Hence, because the DROP payment is a distribution to the member of all or any portion of the balance to the credit of the member in the Plan, the DROP payment is an "eligible rollover distribution" within the meaning of section 402(c)(4) of the Code and section 1.402(c)-2 of the Regulations. Likewise, in accordance with section 1.401(a)(31)-1, Q&A-1, of the Regulations, the DROP payment is an eligible rollover distribution for purposes of section 401(a)(31)(A) of the Code.

Based on the foregoing analysis of the issues presented in your ruling request, the following ruling is issued:

(1) The DROP is not a separate defined contribution plan.

(2) The limitation for defined benefit plans under section 415(b) of Code applies to the Plan with the DROP. The Plan with the DROP satisfies the defined benefit plan limitations under section 415(b) of the Code as long as the provisions continue to be interpreted and administered as described above.

(3) The Plan with the DROP meets the definitely determinable requirement for pension plans under section 1.401-1(b)(1)(i) of the Income Tax Regulations as the Plan is currently written.

(4) The mere fact that Participant contributions that are already being picked-up under the Plan pursuant to section 414(h)(2) of the Code will continued unchanged during participation in the DROP will not result in said contributions being ineligible for pick-up.

(5) Credits to a participant's DROP account are not distributions from the Plan and are not subject to current income taxes or to the additional 10% tax on early distributions under section 72(t) of the Code.

(6) Single sum distributions from a participant's DROP account will be eligible for rollover under section 401(a)(31)(A) of the Code.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

We have sent a copy of this letter to your authorized representative pursuant to a power of attorney on file in this office.

If you require further assistance in this matter, please contact

Sincerely yours,

James E. Holland, Jr.

James E. Holland, Jr., Manager
Employee Plans Technical

MEMORANDUM

February 12, 1997

TO: Robert Blum

FROM: Theodore Rhodes

RE: DROP

Attached are the materials I have relating to the DROP program which did not provide for continuing accruals during the DROP period. Some of the items may be of interest including the discussion of the ADEA on page 21 of the memorandum dated October 2, 1990.

MEMORANDUM

October 2, 1990

TO: [redacted]

FROM: Theodore E. Rhodes
Ellen Kohn
Cynthia L. Moore

RE: Issues Associated With Deferred Retirement Option Plan ("DROP")

The following is our preliminary analysis of the major questions that have arisen in connection with the [redacted] Employees' Retirement System's ("System") establishment of the DROP program.

I. CONSTRUCTIVE RECEIPT

Upon commencement of participation in the DROP program, retirement benefits that otherwise would have been payable to the participant are instead credited to the participant's DROP Account for the period of DROP participation. DROP [redacted] Moreover, during the period of DROP participation, membership in the basic System ceases. DROP [redacted]. Nevertheless, amounts credited to a participant's DROP Account will not be taxable at the time of crediting, because such amounts are not actually distributed from the System Trust and received by the participant at that time.

For taxable years beginning before January 1, 1982, Code section 402(a)(1) provided for the taxation of amounts actually distributed "or made available." Thus, qualified plan participants were subject to tax on amounts constructively as well as actually received during a taxable year. The concept of constructive receipt was removed from Code section 402(a)(1) by Section 314(c)(1) of the Economic Recovery Tax Act of 1981 ("ERTA"), [redacted], which deleted the phrase "or made available" for taxable years beginning after December 31, 1981. The law currently provides that distributions from qualified plans are taxable to the distributee in the year in which such amounts are "actually distributed." Code § 402(a)(1). Consequently, amounts credited to the DROP Account will not be taxable to participants until they are actually received upon the termination of employment.

Moreover, it is our view that, even under pre-ERTA law, amounts credited to the DROP Account would not have been viewed as constructively received by participants prior to the termination of their employment. Prior to ERTA a participant's interest in a qualified trust was treated as constructively received when it was "unconditionally credited to or set apart for him and made subject to his withdrawal or other disposition." [redacted] The two general classes of conditions that operated to prevent constructive receipt were (1) penalties for withdrawal and (2) a prior irrevocable election to defer distribution to a fixed or determinable future time. Id. [redacted] provided that a condition that was without substance would not prevent constructive receipt of a participant's interest. However, deferrals to the termination of employment, for a period of ten years or until retirement were considered substantial.

A participant who wishes to enter DROP must make a prior irrevocable election to defer the receipt of the amounts credited to the DROP Account until the termination of his employment. DROP [redacted]. Thus, the irrevocable election to defer receipt of the amounts credited to the DROP Account would have been sufficient to prevent constructive receipt under pre-ERTA law. See also [redacted] (December 3, 1979)(deferral until termination of employment precludes constructive receipt); [redacted] (March 13, 1980); [redacted] (December 19, 1978) (same).

You have also asked whether an individual who elects a periodic payout under DROP [redacted] will nonetheless be considered in constructive receipt of the lump sum amount in the Account. For the same reasons as set forth above, a participant will be taxed only on the amounts actually distributed to him. Finally, interest earned on the Account will not be taxable to a participant until actually distributed.

While not a constructive receipt question, you have also asked whether amounts in the DROP Account are subject to an IRS levy. Because the amounts held in the DROP Account have not been constructively received by the participant, they are treated as remaining in the pension plan and generally not available to creditors of the participant. <u>See</u> Code § 401(a)(13). However, under [redacted], the anti-assignment rule of Code § 401(a)(13) does not apply with respect to the enforcement of a Federal tax levy made pursuant to Code § 6331. Accordingly, the amounts held in the DROP Account will be subject to an IRS levy under Code § 6331.

II. <u>APPLICABILITY OF CODE SECTION 414(k)</u>

Section 414(k) of the Internal Revenue Code ("Code") provides, in relevant part:

> (k) CERTAIN PLANS.--A defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant shall--
>
> > (1) for purposes of section 410 (relating to minimum participation standards), be treated as a defined contribution plan,
> >
> > (2) for purposes of sections 72(d) (relating to treatment of employee contributions as separate contract), 411(a)(7)(A) (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 401(m) (relating to nondiscrimination tests for matching requirements and employee contributions), be treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan, ...

In [redacted] the Internal Revenue Service ("IRS") ruled that in order to constitute a Code section 414(k) plan, the plan provisions governing the participant's separate account must satisfy the requirements of a defined contribution plan. Code section 414(i) defines a defined contribution plan as:

> a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

In [redacted] the IRS concluded that a separate account established in a defined benefit plan to hold mandatory employee contributions was not a defined contribution plan within the meaning of Code section 414(i), because an assumed rather than actual rate of interest was credited to the account. [redacted].

We understand that under the DROP program, no interest will be credited to a participant's DROP Account during the participation period. Thereafter, interest will be credited at the end of each plan year at a rate equal to the System's rate of return less one-half of one percent. DROP [redacted]. Because the DROP Account will not be credited with the actual interest earned on the Account balance, it is our view that the DROP program should not be considered a Code section 414(k) defined contribution plan within a defined benefit plan.

This view is confirmed by a discussion contained in the preamble to the regulations promulgated by the Treasury Department under Code section 415. The preamble states:

> One commentator questioned the appropriate section 415 treatment to be given a pension plan which provides that, on attaining normal retirement age, the accrued benefit of a participant who works past normal retirement age is physically segregated. The participant is then typically given the right to direct the investment of this segregated account, and will be paid the balance of that account at actual retirement. The commentator suggested that this type of plan involves a defined benefit plan that converts (at least for the individual working past normal retirement age) into a defined contribution plan after normal retirement age for purposes of applying the section 415 limitations.
>
> However, under the regulations, this type of plan is governed by the limitations of section 415(b) at all times, and is not converted into a defined contribution plan after normal retirement age merely because a participant's accrued benefit is physically segregated.

[redacted]

Moreover, although the structure of the DROP program is quite unusual in the context of a defined benefit plan, it should not affect the qualified status of the System if the program is administered in accordance with the applicable requirements of the Code, as discussed more fully below. In [redacted] the IRS provided advice concerning the federal income tax treatment to be accorded the United States Civil Service Retirement and Disability Fund. Under the terms of that plan, employees who terminated from service after becoming entitled to receive an immediate retirement benefit could defer receipt of their retirement benefits. Upon electing to receive benefits, the participant received a lump-sum payment representing accrued monthly installments covering the period from the date of termination to the date the claim for benefits was filed. Thereafter, he received monthly annuity payments for life. Although Rev. Rul. 68-486 dealt with the issue of constructive receipt (and found that there was none), there was no suggestion that the arrangement affected the plan's qualified status. Moreover, numerous plans, including the System, provide for a holding of distributable retirement benefits in the event that a participant cannot be located. We have found no authority to suggest that holding or separately accounting for such amounts disqualifies a defined benefit plan or converts it, in part, into a defined contribution plan.

III. JOINT AND SURVIVOR ANNUITY REQUIREMENTS

We have been asked to consider the joint and survivor annuity requirements for individuals who elect to participate in the DROP program, since governmental plans are not exempt from the requirements of Code sections 401(a)(11) and 417. As we understand the benefit payment procedures under the System, an eligible participant commences the procedure by filing an application with the Board of Trustees of the System. [redacted] Upon application, a member may elect from various forms of benefits, including a qualified joint and survivor annuity ("QJSA"). Rev. Stats. § 42:577. Benefits are effective on the later of the date the application is filed with the Board or the day after the member terminates from service. [redacted] Thus, the annuity starting date under the System, generally is the later of the application filing date or the first day after the member terminates from service.

A participant who enters DROP is considered by the System to be a retired person and to have terminated from service. [redacted]; [redacted]. Benefits that would otherwise have been due the participant are credited to the DROP Account. DROP [redacted]. If, after the participant terminates from DROP he continues employment with the State, his benefits from the System cease being credited to the DROP Account and are essentially suspended. DROP [redacted] When the participant subsequently terminates State employment, benefits recommence. However, the benefit amount will be adjusted upwards to take into account accruals earned after the close of the DROP period, in accordance with DROP [redacted].

The Code and regulations provide that if a participant dies before the "annuity starting date," vested benefits must be paid to the surviving spouse as a qualified preretirement survivor annuity ("QPSA"), unless otherwise waived. Likewise, if a participant survives until the annuity starting date, benefits must be provided in the form of a QJSA, unless waived. Code section 401(a)(11)(A); [redacted] and QJSA rights may apply simultaneously to different portions of a participant's benefit if the annuity starting date has occurred only with respect to a portion of the participant's benefit. Id., Q&A-9. Moreover, a waiver of a QJSA is only effective if it is made within 90 days before the annuity starting date. Id., Q&A-10(a). Finally, if a participant divorces his spouse after the annuity starting date, the participant's spouse on the annuity starting date remains entitled to the QJSA protection under the plan. Id., Q&A-25(b)(3).

Therefore, in order to determine the joint and survivor requirements for DROP participants, it is essential to determine the meaning of the term "annuity starting date" in this context. The annuity starting date is (1) the first day of the first period for which an amount is payable as an annuity, or (2) in the case of a benefit not payable as an annuity, the first day on which all events have occurred that entitle the participant to such benefit. Code section 417(f)(2)(A). Although the Code definition refers to amounts that are "payable," the regulations more narrowly define the annuity starting date as the first day of the period for which "an amount is paid as an annuity or any other form." [redacted] (emphasis added).

The regulations provide special rules governing situations in which (1) an employee begins to receive retirement benefits and then returns to employment and (2) an employee continues to work after normal retirement age but does not receive benefit payments until his termination.

> (d) Other rules--(1) Suspension of benefits. If benefit payments are suspended after the annuity starting date pursuant to a suspension of benefits described in section 411(a)(3)(B) after an employee separates from service, the recommencement of benefit payments after the suspension is not treated as a new annuity starting date unless the plan provides otherwise. In such case, the plan administrator is not required to provide new notices nor to obtain new waivers for the recommenced distributions if the form of distribution is the same as the form that was appropriately selected prior to the suspension. If benefits are suspended for an employee who continues in service without a separation and who never receives payments, the commencement of payments after the period of suspension is treated as the annuity starting date unless the plan provides otherwise.

[redacted].

Although the foregoing regulations do not expressly address the DROP situation, it is our view that a good argument can be made that a participant's annuity starting date with respect to his basic System benefit and amounts credited to the DROP Account is the date he enters the DROP program. Although amounts are not actually paid or payable out of the Trust on that date, the individual is considered retired from the System and is viewed as receiving retirement benefits. The benefits to which he would otherwise be entitled if he terminated employment are credited to the DROP Account and, in the event of his death before actual distribution, will be distributed in accordance with state inheritance laws. Thus, amounts credited to DROP are clearly treated by the System as paid.[1]

Moreover, a DROP participant who remains in employment after the DROP program, should not be treated as having a new annuity starting date when he subsequently retires, at least, with respect to his accrued benefit earned prior to DROP. The DROP situation is analogous to the rule set forth in [redacted] which provides that if benefit payments commence and then are suspended during a period of reemployment, the recommencement of benefit payments is not treated as a new annuity starting date unless the plan provides otherwise.[2]

The additional accruals earned by participants after the DROP program are subject to a different analysis. The regulations provide:

> (2) Additional accruals. In the case of an annuity starting date that occurs on or after normal retirement age, such date applies to any additional accruals after

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[1] The regulations contain a special rule for Code section 414(k) plans that requires each portion of the plan to be treated separately. [redacted] Because we have determined that this is not a 414(k) plan, this section of the regulations is inapplicable.

[2] [redacted] also provides that, unless a plan provides otherwise, if benefits are suspended for an employee who continues in service without a separation and who never receives payments during that service, the commencement of payments when he terminates from service is treated as the annuity starting date. Even if DROP participants are not viewed as receiving payments when amounts are credited to the DROP Account, this section would appear to suggest that the plan provisions govern if the plan provides that the annuity starting date is the date a participant enters DROP.

> the annuity starting date, unless the plan provides otherwise. For example, if a participant who continues to accrue benefits elects to have benefits paid in an optional form at normal retirement age, the additional accruals must be paid in the optional form selected unless the plan provides otherwise. In the case of an annuity starting date that occurs prior to normal retirement age, such date does not apply to any additional accruals after such date.

Id., Q&A-10(d)(2). Thus, if the additional accruals are viewed as occurring after normal retirement age, the original annuity starting date will apply and no additional joint and survivor obligations will arise.

[redacted] provides that for purposes of the QJSA requirements, the term "normal retirement age" has the meaning set forth in Code section 411(a)(8). Thus, although Code section 411(e)(2) provides that governmental plans need only comply with the requirements of Code section 411 as in effect on September 1, 1974, the current definition in Code section 411(a)(8) would appear to be relevant for purposes of determining the System's joint and survivor annuity obligations. Normal retirement age is defined as the earlier of (1) the time specified in the plan at which a participant attains normal retirement age, or (2) the later of the time a participant reaches age 65 or the 5th anniversary of the commencement of plan participation. Code section 411(a)(8). Regulations under section 411(a)(8) provide that if a plan does not specify a normal retirement age, then normal retirement age will be "the earliest age beyond which the participant's benefits under the plan are not greater solely on account of his age or service."

[redacted]

The System does not specify a "normal retirement age," although it does provide criteria for eligibility for an unreduced pension based upon a combination of age and years of service. [redacted]. Therefore, as currently drafted, it appears that the plan's normal retirement age is the earliest age beyond which a participant does not accrue additional benefits. This age is linked directly to each participant's years of service, because annual benefits are based on 2.5% of average compensation times years of service, plus $300, to a maximum of 100% of average compensation. [redacted]. Once a participant works 40 years, his annual benefits will not increase solely on account of his age or subsequent years of service. Thus, for example, the normal retirement age for a participant who retires at age 50 with 30 years of service is 60, not 50. Likewise, the normal retirement age for a participant who retires at age 60 with 10 years of service would be 65 (the later of age 65 or his 5th anniversary of participation). Accordingly, the normal retirement age for participants under the System will vary with each participant's individual circumstances.

In view of this fact, there are many instances in which participation will begin in the DROP program prior to a participant's normal retirement age. In those cases, the DROP annuity starting date will precede the participant's normal retirement age and will entitle such a participant who accrues additional benefits after DROP participation to a new annuity starting date for those accruals.

In order to avoid this result, we would suggest that the provisions of the System be amended to specify that normal retirement age is the date that a participant first becomes eligible to receive an unreduced pension under [redacted] In that way, normal retirement age will always precede the date a participant enters DROP.

It should be recognized that our analysis of the joint and survivor requirements hinges on the argument that a participant's annuity starting date is the date he enters DROP, even though amounts are not distributed from the Trust at that time. Although we believe that this argument has merit, it is our view that this position is likely to be challenged at some point by a disgruntled spouse or a participant whose spouse dies during or after the DROP period. If you consider it important to avoid the possibility of challenge, a second election should be provided prior to the participant's termination from employment.

IV. APPLICATION OF CODE SECTION 415 LIMITS

A. Are DROP payments added to regular benefit payments for purposes of section 415 limits?

Upon termination of employment, a participant is entitled to receive (1) the amount credited to his DROP Account, in either periodic payments or a lump sum, plus (2) regular monthly retirement benefits under the System. Where a participant has continued employment after his period of participation in DROP, the amount credited to the DROP Account includes interest earned on the Account during the period of employment after participation. Thus, the question arises whether the amounts contributed to the DROP Account during the DROP period or the interest credited to the Account, or both, are subject to the limitations of Code section 415.

As set forth above, it is our view that the DROP Account does not constitute a defined contribution plan within a defined benefit plan under Code section 414(k). Moreover, as we indicated, the preamble to the Code section 415 regulations suggests that the DROP Account would be governed by the defined benefit limitations of section 415(b) and would not be "converted into a defined contribution plan . . . merely because a participant's accrued benefit is physically segregated." [redacted]. Thus, the DROP Account should be analyzed under Code section 415(b). [redacted]

Section 415(b) of the Code limits the annual benefit that is payable under a defined benefit plan. Specifically, the annual benefit is limited to the lesser of $90,000 ($102,582 as adjusted for 1990) or 100% of a participant's average compensation for his high three years. Code section 415(b)(1). The term "annual benefit" is defined as "a benefit payable annually in the form of a straight life annuity . . . ." Code section 415(b)(2)(A); [redacted] In addition, to the extent a plan provides for a benefit in any form other than a straight life annuity, the Code provides:

> [T]he determinations as to whether the [Section 415(b)(1) limitation] has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is equivalent to [a straight life annuity].

Code section 415(b)(2)(B). Thus, all amounts considered part of the annual retirement benefit must be taken into account under section 415(b).

As discussed above, it is our view that the amounts contributed to the DROP Account during DROP participation constitute the <u>payment</u> of retirement benefits and, thus, should not be viewed as increasing the annual benefit otherwise payable under the plan. The preamble to the section 415 regulations also suggests that when an accrued benefit is held and not paid it is viewed as "segregated" rather than as an additional accrual. Although there does not appear to be any authority on point, it is our view that benefits that are held in a plan pending payment to a missing participant should not be subject to 415(b). The same reasoning should apply to amounts credited to the DROP Account.

Moreover, the regulations expressly exclude from the definition of the term annual benefit amounts attributable to assets transferred from another qualified plan, employee contributions, and rollover contributions. [redacted] Although these exclusions do not literally cover amounts credited to the DROP Account, the result should not differ simply because amounts are held in the System Trust rather than being transferred to another qualified plan.[3/]

Two rulings address section 415(b) in the context of a transfer of assets to a separate account in a defined benefit plan. In [redacted] (November 25, 1987), a trustee transferred the account balance of a participant in a profit-sharing plan to a defined benefit plan of the same employer. The defined benefit plan maintained separate accounts: one for the account balance transferred from the profit-sharing plan and one for the participant's regular accrued benefit under the defined benefit plan. The IRS ruled that the amounts transferred would not constitute part of the annual benefit for purposes of section 415(b), reasoning that [redacted] provides

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[3/] There is authority that suggests, however, that the plan-to-plan transfer exclusion would not be applicable in this case. In [redacted] (December 16, 1985) a taxpayer requested a ruling that he could withdraw his nondeductible voluntary contributions from a defined benefit plan and replace them at a later date during the same taxable year without the later contribution being considered an annual addition under Section 415(c). The IRS initially ruled that there would not be a second annual addition in this situation, reasoning that the regulations under Section 415(c) define annual addition to exclude a direct transfer of employee contributions from one qualified plan to another. The IRS later withdrew this ruling. The next time this issue arose, in [redacted] (March 5, 1986), the IRS ruled that the replacement of previously withdrawn employee contributions resulted in a second annual addition, reasoning that a withdrawal of employee contributions followed by a replacement of those contributions in the same year was "not among the exceptions mentioned in section 1.415-6(b)(3). . . ." Id. This ruling suggests that the IRS takes a literal view of the exceptions, which might preclude the treatment of the DROP Account as transferred assets.

that "the annual benefit attributable to the assets transferred does not have to be taken into account . . . in applying the limitations of section 415(b)." Id.

The ruling did not mention whether the separate account holding the transferred assets earned interest, nor did it address whether such interest could be excluded in determining the section 415(b) limit. But the ruling, and the regulation, expressly exclude benefits "attributable" to transferred assets, raising at least the implication that both the assets transferred and their earnings may be excluded from the calculation of annual benefits. See also [redacted] (August 26, 1981).

Although we feel fairly comfortable that amounts initially credited to the DROP Account are not taken into account in determining the annual benefit payable under the plan, we feel less comfortable about the result with respect to earnings credited to the Account, despite the language of the regulations and the foregoing letter rulings. In [redacted] the IRS considered a defined benefit plan under which participants received not only the defined benefit specified by the plan but also the balance in their individual account. The individual accounts were credited with earnings in excess of the investment yield assumptions used in the valuation of the plan. The IRS concluded that this plan was a section 414(k) plan. Accordingly, it ruled that the individual account portion of the plan was subject to the limitations of Code section 415(c).

> Because excess earnings under the defined benefit portion of the plan are not used to reduce future employer contributions, as generally would be required, but are credited to the participants' individual accounts and directly increase the participants' accrued benefits, these excess earnings allocations are annual additions to the individual accounts for purposes of section 415(c) of the Code.

Although not directly applicable because it deals with a section 414(k) plan, [redacted] would seem to suggest that where additional amounts in excess of the retirement benefits previously accrued are credited to an individual in a defined benefit plan and increase the participant's benefit under the plan, those amounts should be subject to section 415. Although the amounts transferred to the DROP Account represent payment of, rather than an increase in, a participant's accrued benefit, the interest earned on the DROP Account does seem to provide an additional benefit akin to the benefit discussed in [redacted] We discussed this issue, on a no-name basis of course, with a representative of the IRS. He confirmed our view that the amounts initially credited to the DROP Account should not be considered part of the annual benefit, but that the interest accrued on the Account does represent an additional benefit that should be taken into account under Code section 415. Therefore, it is our view that the annuitized value of the interest credited to a participant in the DROP program should be taken into account in determining the participant's annual benefit.

This result should not have a practical effect in most cases because, as set forth below, average compensation for purposes of section 415 will generally be increasing more rapidly than the participant's 415 annual benefit. However, as to those participants who are affected, you may want to consider the establishment of an excess benefit plan, to the extent permitted by Code section 457.

B. <u>What salary period should be considered the "highest 3 years" for section 415 purposes</u>?

Section 415(b) of the Code defines a participant's high three years as the "period of consecutive calendar years (not more than 3) during which the participant was both an active participant in the plan and had the greatest aggregate compensation from the employer." Code section 415(b)(3). However, the regulations under section 415(b)(3) alter the statutory definition slightly by eliminating the requirement that the high three years be years during which the individual is an active participant:

> For purposes of applying the limitation on benefits described in [Section 415(b)], a participant's high 3 years of service is the period of 3 consecutive calendar years . . . during which the employee has the greatest aggregate compensation . . . from the employer.

[redacted].[4] We confirmed with a representative of the IRS that the IRS views the regulations as controlling on this issue.

Consequently, the employees' three consecutive calendar years of greatest compensation, whether they occur before, during or after participation in the DROP program, should be the period used for purposes of determining average compensation under Code section 415(b)(3).

V. APPLICATION OF THE AGE DISCRIMINATION IN EMPLOYMENT ACT ("ADEA")

As set forth above, participants in the DROP program are deemed by the System to be retired and do not accrue additional pension credit under the basic System while their participation continues. DROP [redacted]. If a participant remains employed after the DROP period, accruals resume. However, such accruals are based solely upon service performed after the DROP period and do not include post-DROP compensation

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[4] This portion of the regulation was not changed from its proposed form. The preamble to the proposed regulation provided:

> The regulations provide that a participant's high three years of service is the period of three consecutive calendar years during which the employee had the greatest aggregate compensation from the employer.

[redacted]

unless the participant remains employed for at least 36 months following the termination of the DROP period.[5/]

Under certain circumstances, the total accrued benefit of a participant who elects the DROP program may be less than the benefit he would have earned had he simply remained in the basic System until his termination.[6/] Therefore, it is possible that a participant who did not fully understand the significance of his decision to enter the DROP program may seek to bring an action under the ADEA to recover additional pension benefits.

In 1986, Congress enacted the Omnibus Budget Reconciliation Act of 1986 ("OBRA") which amended the ADEA by adding a new Section 4(i), which provides:

> (1) Except as otherwise provided in this subsection, it shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit plan which requires or permits--
>
> (A) in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or

---

5/ This dual track of benefit accruals for participants who work after participating in DROP may violate the requirements for the provision of nondiscriminatory benefits under Code section 401(a)(4). We have not analyzed this issue at this time since the IRS in its recent proposed regulations issued on May 14, 1990, exempted governmental plans from the non-discrimination requirements until plan years beginning after December 31, 1992. [redacted]. In addition, we have not considered whether the provision of benefit accruals violates the rules of Code section 411 since governmental plans are exempt from these requirements. Code section 411(e)(1)(A).

6/ ost likely to occur where a participant has a ry increase after entering the DROP program.

the reduction of the rate of an employee's benefit accrual, because of age,

* * * *

(2) Nothing in this section shall be construed to prohibit an employer, employment agency, or labor organization from observing any provision of an employee pension benefit plan to the extent that such provision imposes (without regard to age) a limitation on the amount of benefits that the plan provides or a limitation on the number of years of service or years of participation which are taken into account for purposes of determining benefit accrual under the plan.

(3) In the case of any employee who, as of the end of any plan year under a defined benefit plan, has attained normal retirement age under such plan--

(A) if distribution of benefits under such plan with respect to such employee has commenced as of the end of such plan year, then any requirement of this subsection for continued accrual of benefits under such plan with respect to such employee during such plan year shall be treated as satisfied to the extent of the actuarial equivalent of in-service distribution of benefits, and

(B) if distribution of benefits under such plan with respect to such employee has not commenced as of the end of such year in accordance with section 1056(a)(3) of this title and section 401(a)(14)(C) of title 26, and the payment of benefits under such plan with respect to such employee is not suspended during such plan year pursuant to section 1053(a)(3)(B) of this title or section 411(a)(3)(B) of title 26, then any requirement of this subsection for continued accrual of benefits under such plan with respect to such employee during such plan year shall be treated as satisfied to the extent of any adjustment in the benefit payable under the plan during such plan year attributable to the delay in the distribution of benefits after the attainment of normal retirement age.

The provisions of this paragraph shall apply in accordance with regulations of the Secretary of the Treasury. Such regulations shall provide for the application of the preceding provisions of this

> paragraph to all employee pension benefit plans subject to this subsection and may provide for the application of such provisions, in the case of any such employee, with respect to any period of time within a plan year.

29 U.S.C. § 623(i).[7] The Conference Report to OBRA provides:

> It is the intention of the conferees, in adopting the amendments to ADEA (new sec. 4(i)), that the requirements contained in section 4(i) related to an employee's right to benefit accruals . . . shall constitute the entire extent to which ADEA affects such benefit accrual and contribution matters with respect to such plans on or after the effective date of such provisions.

H.R. Report 99-1012, Conference Report to Accompany H.R. 5300, 99th Cong., 2d Sess., at 382.[8]

We believe that a good argument exists that the DROP program violates neither the spirit nor the letter of section 4(i) of the ADEA. That section prohibits a defined benefit plan from ceasing or reducing accruals "because of age." The legislation was aimed at preventing pension plans from ignoring altogether an employee's post-normal retirement age years of service. 132 Cong. Rec. S12966-03 (1986). The System does not ignore years of service performed by older employees. Rather, it provides all participants the opportunity to receive credit for years of service to a maximum of 100 percent of compensation or

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[7] Section 411 of the Code was amended at the same time to add a parallel requirement. That provision does not apply to governmental plans, however.

[8] For this reason, we do not believe that the more general prohibitions against discrimination contained in the ADEA and the legislation pending in Congress to overrule the Supreme Court's decision in <u>Betts</u> are relevant to this inquiry.

roughly 40 years of service.[9/] In addition, it provides employees who are eligible for an unreduced pension an alternative benefit under the DROP program. The offer of this additional form of benefit, when viewed in the context of the basic benefit offered to all employees, should not violate section 4(i) of the ADEA. The preamble to the proposed IRS regulations provides that accruals will be considered reduced on account of age

> if optional forms of benefits, ancillary benefits or other benefits, rights or features . . . that are --ovided with respect to benefits or allocations prior such age are <u>not</u> provided (on terms that are at st as favorable to employees) with respect to efits or allocations after such age.

6,010 much affecte Har

11876 (April 11, 1988) (emphasis added). Where, as ployees are offered an optional form of benefit not nger employees, there should be no finding of age

Nonetheless, if the DROP program, and its effect on post-DROP period accruals, is viewed in isolation, certain participants may be able to make out an argument that their rate of accrual was reduced because of DROP. During the DROP period, if participants are viewed as receiving payments, an argument can be made that there is no violation of the ADEA, so long as the

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9/ The proposed regulations promulgated by the IRS under Code section 411 also apply to section 4(i) of the ADEA. 53 Fed. Reg. 11876 (April 11, 1988). Those regulations expressly permit defined benefit plans to limit the number of years of service taken in account for purposes of determining accrued benefits and to limit benefits to a specified percentage of compensation. Prop. Treas. Reg. § 1.411(b)-2(b)(2)(i).

actuarial value (determined as a monthly benefit) of the amount credited to the DROP Account exceeds the benefit that would otherwise accrue under the basic System. ADEA, section 4(i)(3)(A); Prop. Treas. Reg. § 1.411(b)-2(b)(4)(iv) Ex. 3.

After the DROP period, participants who continue in service receive additional accruals. However, those accruals will often not match accruals that would have been provided under the basic System. Because the Treasury regulations permit plans to provide different rates of accruals "on a uniform and consistent basis," an argument could be made that the lesser accrual for DROP participants is acceptable. Because, however, participation in DROP depends, in certain circumstances, on the participant's age, the strength of this argument is questionable.[10]

Therefore, although we believe a good argument exists that the DROP program does not violate the ADEA, you should be aware that possible challenges may be made on this ground. In order to reduce to a minimum the likely success of such challenges, we would suggest that you disclose fully to each prospective DROP participant the consequences of their election.

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[10] In any event, to avoid actuarially adjusting the benefits of participants who remain employed after the DROP program, such participants should be provided a suspension of benefits notice when their DROP participation ceases. Prop. Treas. Reg. § 1.411(b)-2(b)(4)(iv) Ex. 1.

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THEODORE E. RHODES
(202) 429-8272

November 20, 1990

VIA FEDERAL EXPRESS

[redacted]

Dear [redacted]

I apologize for the delay in getting this last section on the taxation of distributions to you. We found the issues more difficult than anticipated. After you have an opportunity to review the enclosed section and have given us your comments, we can prepare the entire memorandum in final form.

Sincerely,

Theodore E. Rhodes

TER:jm
Enclosure
bcc: Ellen Kohn, Esq.
Preston Rutledge, Esq.
Cindie Moore, Esq.

V. TAXATION OF DISTRIBUTIONS

You have advised us that employee contributions paid prior to January 1, 1984 were not tax sheltered and that the System uses the simplified method to calculate the excludable amount of the monthly retirement benefit. You have asked us to discuss the effect that the DROP program will have on the taxation of distributions from the System. In particular you have asked: Should an excludable amount be calculated for the amount credited to the DROP Account? If so, how should it be calculated and how should it be reported? Is the treatment different if the retiree receives a lump sum distribution of the DROP Account in lieu of monthly disbursements over the number of years? If an excludable amount must be calculated for the DROP Account, what are the reporting requirements we must follow if we are unable to calculate the excludable amount due to System limitations?

Based on the facts and analysis set forth below, it is our opinion that the System may use the simplified method of calculating the excludable amount with respect to the entire System benefit regardless of whether the DROP benefit portion is distributed in periodic payments or in a lump sum. In the limited circumstance where a participant initially chooses to receive his DROP benefit in the form of a periodic payment, and subsequently chooses to receive the DROP benefit in a single lump sum, it will be necessary for the System to calculate an excludable amount with respect to the lump sum payment. <u>See</u> Section C(3), <u>infra</u>.

A. <u>Factual Background</u>

During the period of DROP participation, membership in the basic System ceases and the participant is considered to be in a retired status. DROP [redacted] Upon commencement of participation in the DROP program, retirement benefits that otherwise would have been payable to the participant are instead credited to the participant's DROP Account for the period of DROP participation. DROP [redacted]. The monthly credit to the DROP Account is calculated on the basis of the participant's final average compensation and creditable service as they exist on the date participation in the DROP program commences. DROP [redacted] The DROP Account is not credited with employee contributions at any time. Further, no interest is credited to a participant's DROP Account during the DROP participation period. After DROP participation ends, however, interest is credited to the DROP Account at the end of each plan year at a rate equal to the System's rate of return less one-half of one percent. DROP [redacted].

Upon termination of employment, a participant may begin to receive both his regular monthly retirement benefit and the amount held in his DROP Account. DROP [redacted]. The participant may choose to receive his DROP benefit either in a single lump sum or in periodic payments in any manner approved by the Board. DROP [redacted]. If a participant chooses a periodic payment, it is our understanding that the participant may change his election during the first calendar year after payments begin and receive the remaining amount in his DROP Account in a single lump sum.

A participant's regular monthly retirement benefit is calculated as follows: First, if a participant does not continue employment after the DROP participation period, his monthly retirement benefit is equal to his "base benefit". DROP [redacted].1/ Second, if a participant continues employment after DROP participation for a period of less than 3 years, his regular retirement benefit is equal to his base benefit plus an additional amount calculated on the basis of the service credit for the additional employment and the participant's final average compensation as it existed at the commencement of DROP participation. DROP [redacted]. Third, if a participant continues employment after DROP participation for a period of 3 years or more, his regular retirement benefit is equal to his base benefit plus an additional amount calculated on the basis of the service credit for the additional employment and the participant's final average compensation for the period of

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1/ A participant's "base benefit" is an amount equal to the monthly credit to the DROP Account, as calculated at the commencement of DROP participation, plus conversion of sick and annual leave, if any, which does not exceed the amount of sick and annual leave credited to the participant at the commencement of DROP participation. DROP [redacted].

employment after termination of DROP participation. DROP [redacted]. Finally, the regular monthly retirement benefit will not be adjusted for any cost of living adjustments granted on or before one year following termination of participation in DROP and employment. DROP [redacted]. Thereafter, regular monthly retirement benefits will be increased by any cost of living adjustments that may be granted. Thus, regardless of whether a participant continues employment after his participation in the DROP program ends, the amount of his regular monthly retirement benefit will be somewhat greater than the amount of the monthly credit to the DROP Account.

Section 402(a)(1) of the Code provides that the amount actually distributed to any distributee by a qualified plan shall be taxable to him in accordance with the rules set forth under section 72 regarding the taxation of annuities. Section 72 provides rules relating to the taxation of amounts received under life insurance, endowment and annuity contracts and, in general, provides that amounts subject to section 72 are includable in the gross income of the recipient "except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid." Code section 72(a); Treas. Reg. § 1.72-1(a).[2/]

[2/] After-tax employee contributions to a qualified plan are treated as "consideration paid for the contract" for purposes of section 72. Code section 72(f); See also PLR 8618061 (February 7, 1986) (the investment in the contract for purposes of section 72 generally will be the employee's contribution to the plan).

B. Analysis

1. Single Contract v. Separate Contract

Treasury regulations provide that, for purposes of applying section 72 to distributions from qualified plans, "each separate program of the employer consisting of interrelated contributions and benefits shall be considered a single contract." Treas. Reg. § 1.72-2(a)(3)(i). Therefore, as a threshold matter it is necessary to determine whether or not the regular retirement benefit and the DROP benefit constitute one separate program of interrelated contributions and benefits.

The regulations provide that the existence in a plan of optional forms of distribution does not result in separate contract treatment where the availability of the options does not affect the total amount received under the Plan. For example, in Treas. Reg. § 1.72-2(a)(3)(iv), Example (2), a participant in a profit-sharing plan was entitled to an in-service periodic distribution of the amount in his account during any period in which he was absent from work due to a personal injury or sickness. Upon separation from service, a participant was entitled to receive a periodic distribution or a distribution in a lump sum. The example concludes that the profit-sharing plan consisted of only one separate program of interrelated contributions and benefits, because it was the total amount received under all the options and not the amount received under any one option that was interrelated with the contributions to the plan. Id.

Similarly, in PLR 8946059 (August 23, 1989), an employer established a defined benefit plan, pursuant to a collective bargaining agreement, under which participants received benefits based on both employer and employee contributions. The normal form of benefit under the plan was a monthly life annuity. The plan provided an optional form of benefit under which a participant could elect to receive an actuarially equivalent cash payment in lieu of one-half of his monthly life annuity. Further, the participant could elect to receive the cash payment either in a lump sum or in equal monthly installments over a term certain of up to three years.

The employer sought a ruling that all benefit payment options under the defined benefit plan would be considered as received under the same program of interrelated contributions and benefits. Referring to the rule that all payments which are attributable to a separate program of interrelated contributions and benefits are considered as received under a single contract, the IRS stated:

> Generally, if a plan distribution causes a reduction in future annuity payments, this distribution would not be from a separate contract.

Id. The IRS then ruled that the various benefit options available under the defined benefit plan would be considered as received under the same program of interrelated contributions and benefits. Id.

Finally, in Rev. Rul. 68-486, 1968-2 C.B. 184, a Federal civil service employee waited five years after his retirement to file a claim for retirement benefits, even though he was entitled to begin receiving a regular monthly annuity for life at the time of his retirement. He received a lump sum payment representing accrued monthly installments covering the five-year period and, thereafter, received regular monthly annuity payments. The portion of the lump sum payment representing the first three years of accrued monthly installments exceeded his total contributions to the Civil Service Retirement Fund. Accordingly, the IRS ruled that only that part of the lump sum payment that exceeded his contribution to the fund was includable in gross income, because the retiree satisfied the three-year basis recovery rule in effect at that time. While this ruling does not expressly discuss the single versus separate contract issue, there was no suggestion in the ruling that the lump sum amount and the monthly annuity amount should be treated separately.

Because the amount credited to a participant's DROP Account is directly dependent upon the participant's base benefit, future accruals are affected by DROP participation and the DROP Account can be viewed as representing nothing more than a build-up of the participant's base benefit within the System, the foregoing rulings suggest that the regular retirement benefit and the DROP benefit should be treated as received under a single contract for purposes of section 72.[3/]

2. Annuity v. Nonannuity

The excludable amount of a distribution received from a qualified plan is determined under section 72(b) of the Code if the distribution is treated as an "amount received as an annuity." Code section 72(b); Treas. Reg. § 1.72-4. On the other hand, the excludable amount is determined under section 72(e) if the distribution is treated as an "amount not received as an annuity." Code section 72(e). The formula for calculating

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[3/] PLR 9019063 (February 14, 1990) also provides support for our view that there is a single contract. In PLR 9019063 an employer sought a ruling that employee and employer contributions to a contributory defined benefit plan would constitute separate contracts for purposes of section 72. The reasons for the IRS' refusal to issue such a ruling are instructive. The IRS noted that Code section 414(k) provides that a defined benefit plan that provides a benefit derived from an employer contribution, which is based partly on the balance of a separate account for a participant, shall, for purposes of section 72(d) (relating to the treatment of employee contributions under a defined contribution plan as a separate contract) be treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of the benefits under the plan. Id. The IRS stated, however, that a defined benefit plan is to be treated as a defined contribution plan only to the extent that the contributions maintained under the separate account are credited with actual earnings. Because participant contributions to the plan were not credited with actual earnings, the IRS ruled that the plan constituted a single contract for purposes of section 72. As noted above, the DROP Account is not credited with actual interest and, therefore, we have previously concluded that the DROP program is not a section 414(k) defined contribution plan within a defined benefit plan. Given that the DROP program is not a section 414(k) plan, PLR 9019063 suggests that the DROP program will be a single contract for purposes of section 72. See also PLR 8926031 (March 31, 1989) (mandatory employee and matching employer contributions to state pension fund do not constitute a separate contract).

the excludable amount differs for annuities and nonannuities, and the simplified method of calculating the excludable amount set forth in IRS Notice 88-118, 1988-2 C.B. 450, is applicable only to annuities to be paid for the life of the employee or the joint lives of the employee and beneficiary. Id. at 451. It is therefore necessary to determine whether a participant's distribution from the System, which will be composed of his DROP Account, as well as pre and post-DROP participation benefit accruals, will be treated as an annuity or a nonannuity for purposes of section 72.

Treasury Regulations define "amounts received as an annuity" as amounts that are payable at regular intervals over a period of more than one full year, provided the total of the amounts payable or the period for which they are to be paid can be determined as of the date the payments are deemed to begin. Treas. Reg. § 1.72-1(b). In addition, the regulations provide:

> [Payments] are considered "amounts received as an annuity" only in the event that all the following tests are met:
>
> (i) They must be received on or after the "annuity starting date" as that term is defined in § 1.72-4(b);
>
> (ii) They must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly or otherwise) over a period of more than one full year from the annuity starting date; and
>
> (iii) Except as indicated in subparagraph (3), the total of amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with

> such terms and in accordance with sound actuarial theory.

Treas. Reg. § 1.72-2(b)(2). Subparagraph (b)(3)(i) provides that, notwithstanding the requirement of subdivision (iii) above:

> [I]f amounts are to be received for a definite or determinable time (whether for a period certain or for a life or lives) under a contract which provides -
>
> (a) That the amount of the periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans) cost of living indices or similar fluctuating criteria,
>
> * * *
>
> each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time that the periodic payments are to be made. . . to this extent, the payments received shall be considered to represent a return of premiums or other consideration paid and shall be excludable from gross income in the taxable year in which received . . . to the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient.

Treas. Reg. § 1.72-2(b)(3)(i). Thus, payments that meet the three part definition in Treas. Reg. § 1.72-2(b)(2) are considered to be annuity payments. Payments that fail the definition of Treas. Reg. § 1.72-2(b)(2) solely because they fail the requirements of subdivision (iii) by reason of a feature that permits the amount of the periodic payment to vary in accordance with, for example, investment experience or cost of living adjustments, will be treated as an annuity to the extent provided in subparagraph (b)(3), with the result that each payment will be excludable from income to the extent it represents a return of employee contributions.[4]

Payments that do not meet the above definition are considered to be "amounts not received as an annuity." Treas. Reg. § 1.72-1(b). See also PLR 9023076 (March 13, 1990).[5] The regulations further define a nonannuity as an amount received under a contract to which section 72 applies if (1) the annuity definition is inapplicable; (2) the annuity definition is applicable but the annuity payments received differ either in amount, duration, or both, from those originally provided under the annuity; or (3) the annuity definition is applicable but the annuity payments are received by a beneficiary after the death of the annuitant in full discharge of the obligation under the contract and solely because of a guarantee. Treas. Reg. §§ 1.72-11(a)(1), (e), (f). The regulations further provide that amounts in the nature of dividends, refunds, payments in full discharge of the contract or surrender payments also are treated as "amounts not received as an annuity." Treas. Reg. §§ 1.72-11(b), (c), (d).

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[4] The effect of Treas. Reg. § 1.72-2(b)(3)(i) is that "extra" amounts, such as earnings or cost of living adjustments, will be includable in income where, as here, the investment in the contract is less than the total expected return. Consequently, increases in annuity payments should be fully includable in gross income.

[5] One commentator has referred to the nonannuity provision as encompassing the "residue" remaining after the more specialized rules of Section 72(b) have been applied. Bittker & Lokken, 1 Fed. Tax'n of Income, Estates and Gifts ¶ 12.4.1 (2nd Ed. 1989).

As set forth above, a payment is treated as an annuity only if it is received on or after the "annuity starting date." Treas. Reg. § 1.72-2(b)(2)(i). Therefore, in order to determine the proper application of section 72, it is essential to determine the meaning of the term "annuity starting date." The annuity starting date is defined as the "first day of the first period for which an amount is received as an annuity." Code section 72(c)(4). The regulations further provide that the first day of the first period for which an amount is received as an annuity is the later of:

> (i) The date upon which the obligations under the contract become fixed, or
>
> (ii) The first day of the period (year, half-year, quarter, month, or otherwise depending on whether payments are to be made annually, semiannually, quarterly, monthly or otherwise) which ends on the date of the first annuity payment.

Treas. Reg. § 1.72-4(b)(1).

Looking only at the second prong of this test, it is possible to argue that the annuity starting date should be the date participation in DROP commences. Rev. Rul. 70-490, 1970-2 C.B. 11, provides some support for such an interpretation. In Rev. Rul. 70-490 an employee died while still in Federal service. His surviving spouse was entitled to receive a survivor annuity benefit on the day after her spouse died. The spouse did not file a claim for her survivor annuity for over a year. Ultimately, fifteen months passed before she received her check. The first payment included an amount representing fourteen months of survivor annuity payments and, thereafter, she received a monthly payment. Quoting Treas. Reg. § 1.72-4(b)(1), the IRS ruled that the annuity obligation was fixed at the time of the employee's death and that the annuity starting date was the day after the employee died. Further, the Service ruled that the same rationale and result would apply in the case of a retired Federal employee who did not file a claim for his annuity until some time after his retirement.

Treating the annuity starting date as the date participation in DROP commences would be consistent with our conclusion under section 417 of the Code regarding the annuity starting date in the joint and survivor annuity context. There is an important difference, however, between the annuity starting date definition under section 72 and the definition under section 417. Unlike section 417, the regulations under section 72 provide that the annuity starting date shall be the later of (1) the first day of the period which ends on the date of the first annuity payment or (2) the date on which the obligations under the contract become fixed. See Treas. Reg. § 1.72-4(b)(1). As set forth above, a participant's regular retirement benefit is not fixed until termination of participation in DROP and employment. Consequently, it is our view that the annuity starting date for purposes of section 72 will be the date the participant terminates employment because that is the date that the participant's actual regular retirement benefit becomes fixed, taking into account any benefits attributable to employment after the end of the DROP participation period.

Given this definition of the annuity starting date, it is evident that the regular retirement benefit payable upon termination of employment satisfies the regulatory definition of an amount received as an annuity. The payments will be received on or after the annuity starting date, will be payable in monthly installments over a period of more than one full year after the annuity starting date and, with the exception of the possibility of cost of living adjustments, the total amount payable will be determinable at the annuity starting date through the use of mortality tables and in accordance with sound actuarial theory. Treas. Reg. § 1.72-2(b)(2). As provided in Treas. Reg. § 1.72-2(b)(3)(i), the regular retirement benefit will be treated as an annuity, to the extent provided therein, even though the benefit payments may later increase due to cost of living adjustment.

The situation regarding the DROP Account is more complicated. A participant may receive the amount credited to his DROP Account in a single lump sum. DROP [redacted]. Alternatively, a participant may elect to have amounts paid in monthly installments. Id.

A lump sum payment does not meet the regulatory definition of an amount received as an annuity. Treas. Reg. §§ 1.72-1(b), 1.72-2(b)(2)(ii). Therefore, lump sum DROP Account payments will not be treated as annuities. See also PLR 9025075 (March 27, 1990) (single sum payment is an amount not received as an annuity).

If, however, periodic DROP Account payments are required to be made for a term certain, (e.g., five, ten or fifteen years) such payments will satisfy the regulatory requirement for an annuity that either the total amount payable under the annuity contract, or the period for which the amounts are to be paid, is determinable as of the date payments begin. Treas. Reg. §§ 1.72-1(b), 1.72-2(b)(2)(iii). Moreover, as provided in Treas. Reg. § 1.72-2(b)(3)(i), this result will apply even though the amount of the payments may vary due to investment experience.

If, on the other hand, payments are permitted to be made for an indefinite period until the DROP Account is exhausted, it will not be possible on the date payments begin to determine the period for which amounts are to be paid or the total amount payable, since, as noted above, amounts held in the DROP Account during the distribution period are credited with interest. _See_ Treas. Reg. §§ 1.72-2(b)(2)(iii), 1.72-2(b)(3)(i). Such payments will nevertheless be treated as annuities, however, because of the following special rule:

> If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, the requirements of subdivision (iii) are met with respect to the payments determinable at the outset by means of computations involving the fixed interest rate, but any payments received after the expiration of the period determinable by such computations shall be [fully] taxable . . . .

Treas. Reg. § 1.72-2(b)(2).

We concluded in Section B(1) above that the regular retirement benefit and the DROP benefit would be treated as received under a single contract. Thus, the question arises whether the regular retirement benefit will be treated as an annuity notwithstanding that it will be analyzed under section 72 in conjunction with either a lump sum nonannuity DROP benefit or a periodic DROP benefit payable in the form of an annuity.

In PLR 8946059 (August 23, 1989), a defined benefit plan provided three distribution alternatives: (1) a monthly life annuity, (2) a lump sum payment in an amount equal to the actuarial equivalent of one-half of the monthly life annuity, combined with a reduced monthly life annuity or (3) an installment payment for up to a three-year term certain in an amount equal to the actuarial equivalent of one-half of the monthly life annuity, combined with a reduced monthly life annuity. The IRS ruled that the payments under all of the options would be treated as received under a single contract for purposes of section 72. See p. 6, supra. The IRS then ruled that where a participant chooses the monthly life annuity and lump sum option, the "annuity portion" constitutes an amount received as an annuity because such portion "will be received on or after the annuity starting date . . . will be payable in periodic installments at regular intervals over a period of more than one full year . . . and the total of the amounts payable is determinable at the annuity starting date." PLR 8946059. Thus, even though the benefit payment included an annuity element and a nonannuity element and the benefit was treated as received under a single contract, the monthly life annuity was still treated as an amount received as an annuity for purposes of section 72. Consequently, in our view the regular retirement benefit will be treated as an annuity under section 72 even where it is combined with a lump sum DROP payment.

PLR 8946059 also addressed the question whether an amount is treated as an annuity under section 72 notwithstanding that it is combined under the same contract with another annuity payable for a different term. One of the distribution options available in PLR 8946059 was an installment payment for a term certain of up to three years in an amount representing the actuarial equivalent of one-half of the participant's monthly life annuity, combined with a reduced monthly life annuity. The Service ruled that both the monthly life annuity and the installment payments would be treated as an amount received as an annuity. Consequently, in our view, both the regular retirement benefit and the periodic DROP benefit will constitute amounts received as annuities for purposes of section 72 notwithstanding that both benefits will be treated as received under a single contract.

C. Excludable Amount

The exclusion ratio for amounts received as annuities is the ratio determined by dividing the investment in the contract by the expected return from the annuity payments. Code section 72(b)(1); Treas. Reg. § 1.72-4(a)(1)(i). The expected return in the case of a life annuity is determined by reference to the life expectancy tables provided in Treas. Reg. § 1.72-9. See Treas. Reg. § 1.72-5(a) & (b). In general, the expected return is the total annuity payment to be received in a given year divided by the applicable life expectancy multiple.[6/] Id. Nonannuity amounts received after the annuity starting date are fully includable in gross income. Code section 72(e)(2)(A).

Because of the complexity of calculating the exclusion ratio under the general rule of section 72(b), on November 15, 1988, the IRS promulgated IRS Notice 88-118, 1988-2 C.B. 450, which provides a simplified method for calculating the excludable amount. The simplified method may be used, and payors may report the taxable portion of annuity distributions on Form W-2P, where

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[6/] For nonannuity amounts received before the annuity starting date, the exclusion ratio is determined by dividing the participants' employee contributions by the total vested account balance or vested accrued benefit. Code sections 72(e)(2)(B) & 72(e)(8)(B). There is a limited exception to the pro rata treatment accorded nonannuity payments received before the annuity starting date. Code section 72(e)(8)(D) permits the entire amount of the employee contributions to be recovered first, after which the amounts are included in gross income. But the exception applies only to plans which, on May 5, 1986, allowed employees to withdraw their contributions before separation from service. The exception therefore does not apply to the System.

(1) the annuity payments depend upon the life of the employee or the joint lives of the employee and the beneficiary, (2) the annuity payments are made from a qualified plan and (3) the distributee is less than age 75 when the annuity payments commence, or if the distributee is age 75 or older, there are less than five years of guaranteed payments.[7/] In addition, under the simplified method no adjustments are required in the event an annuity payment is increased after the excludable amount is originally calculated. 1988-2 C.B. 451-52.

The System currently uses the simplified method of calculating the excludable amount of a participant's retirement benefit. Because the benefit payable to a participant who participates in the DROP program will represent a combination of the System's regular retirement benefit, which is a life annuity, and either a lump sum or periodic DROP payment, the question arises whether the System may continue to use the simplified method with respect to such participants.

Notice 88-118 does not address the question of whether a payment that combines a life annuity with some other form of payment is nevertheless eligible for the simplified method. In addition, there are no rulings under Notice 88-118 that discuss this issue. In our view, however, for the reasons set forth below, the System should be permitted to continue using the simplified method regardless of the form of DROP payment chosen by the participant.

7/ We have assumed for purposes of this memorandum that the System is designed to accommodate the age 75 limitation.

1. <u>Regular Retirement Benefit/Lump Sum DROP Payment</u>

In PLR 8946059, as modified by PLR 9025075 (March 27, 1990), the IRS ruled that where one-half of the benefit received from a defined benefit plan was received as a monthly life annuity and one-half was received in a lump sum payment, the exclusion ratio for the annuity portion should be calculated under section 72(b) and the exclusion ratio for the lump sum payment should be calculated under section 72(e). <u>See</u> PLR 8946059; PLR 9025075. Thus, notwithstanding that the benefits were treated as received under a single contract, the exclusion ratio for each benefit element was calculated in accordance with the rules applicable to each element.

In our view, because the excludable amount applicable to the regular retirement benefit must be calculated in accordance with the rules under Code section 72(b), the simplified method provided in Notice 88-118 should be available, notwithstanding that a portion of the benefit is payable in a lump sum. Although Notice 88-118 does not expressly address this question, our view is supported by the regulations which provide, in part:

> The exclusion ratio shall be applied only to amounts received as an annuity within the meaning of that term under paragraph (b)(2) and (3) of § 1.72-2 . . . For the treatment of amounts not received as an annuity, see section 72(e) and § 1.72-11.

Treas. Reg. § 1.72-4(a)(3).

We have also discussed this issue generally on a "no names" basis with an attorney in the IRS's Office of Chief

Counsel. The attorney would not directly express his views with regard to the availability of Notice 88-118 in the case of what he termed "hybrid" payments.[8] However, he made the following observations which we believe support the use of the simplified method regardless of the form in which the DROP benefit is distributed.

The IRS attorney stated that the underlying purpose of Notice 88-118 is to aid payors in calculating the excludable amount whenever a life expectancy calculation is involved, i.e., whenever the calculation of the exclusion ratio requires reference to the life expectancy tables provided in Treas. Reg. § 1.72-9. Significantly, whenever an annuity is payable for one or more lives, Treas. Reg. § 1.72-5 requires the determination of a life expectancy multiple based on the tables provided in Treas. Reg. § 1.72-9. See Treas. Reg. § 1.72-5(a) & (b). Consequently, the use of the simplified method should be permissible where, as here, the regular retirement benefit is payable in the form of a life annuity because, notwithstanding that a lump sum also is payable, the payor would be required to consult the life expectancy tables in order to calculate the exclusion ratio.

The attorney also observed that the use of the simplified method is both favored and encouraged by the IRS. Indeed, he stated that in analyzing the availability of the simplified method the question one should ask is whether there is anything in Notice 88-118 that prohibits its use. Consequently,

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[8] The attorney did confirm, however, that the simplified method is available where Treas. Reg. § 1.72-11(f) applies. See discussion of Treas. Reg. § 1.72-11(f) in Section C(3), infra.

because Notice 88-118 does not expressly address the question whether the simplified method is available where only a portion of the benefit payment constitutes a life annuity, it is our view that the simplified method should be applied to the regular retirement benefit, and the entire lump sum payment will be taxable under Code section 72(e)(2)(A).[8]

2. <u>Regular Retirement Benefit/Periodic DROP Payment</u>

Instead of a lump sum payment, a participant may choose to receive his DROP benefit in the form of a periodic annuity payment. PLR 8946059 also addressed the question of how to calculate the exclusion ratio where one-half of the benefit is received as a monthly life annuity and one-half is received as an annuity for a term certain. The IRS applied the special rule of Treas. Reg. § 1.72-4(e), which governs the calculation of an exclusion ratio where two or more annuity elements are provided under a single contract. The regulation provides, in part:

> Where two or more annuity elements are provided under a [single] contract . . . an exclusion ratio shall be determined for the contract as a whole and applied to all amounts received as an annuity under any of the annuity elements. To obtain this ratio, the investment in the contract determined in

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[8] It is important to note that if a nonannuity payment is received <u>before</u> the annuity starting date it is necessary to calculate an exclusion ratio in accordance with the rules under Code sections 72(e)(2)(B) & 72 (e)(8)(B). <u>See</u> p. 18, fn. 6, <u>supra</u>. Therefore, it is important that the System ensure that lump sum payments from the DROP Account are not distributed until on or after the participant receives his first regular retirement benefit payment. Such a procedure should ensure that the System will never be required to calculate an exclusion ratio under Code section 72(e) for such amounts.

> accordance with § 1.72-6 shall be divided by the aggregate of the expected returns found with respect to each of the annuity elements in accordance with § 1.72-5.

Treas. Reg. § 1.72-4(e)(1)(i). As noted at p. 21, <u>supra</u>, Treas. Reg. § 1.72-5 requires a payor to consult the life expectancy table in order to calculate the exclusion ratio. Consequently, although there is no authority on point, it is reasonable to argue that the simplified method should be available in this circumstance, because the purpose of Notice 88-118 is to relieve payors of the necessity of using the life expectancy tables. Further, Notice 88-118 does not expressly prohibit the use of the simplified method in these circumstances.[10]

3. <u>Periodic DROP Payment Converted to Lump Sum</u>

Finally, you have advised us that the Board may permit participants who initially elect to receive periodic payments from their DROP Account to change their election and receive a lump sum payment. You have asked us to advise you as to the effect, if any, the conversion of a periodic DROP payment to a lump sum would have on the calculation of the excludable amount.

Treas. Reg. § 1.72-11(f) provides a special rule where an annuitant receives a lump sum payment after the date of the first annuity payment and thereafter receives annuity payments in a reduced amount for the same term. In this situation, a portion

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[10] In addition, it would not be in the IRS's interest to argue that the simplified method is not available. If the System calculated excludable amounts for the two annuity elements separately, the excluable amounts would be recovered more quickly because the periodic DROP payments will be payable for a shorter term than the regular retirement benefit.

of the annuity is considered to have been surrendered or redeemed and the exclusion ratio originally determined for the annuity continues to apply to the reduced annuity amounts. Treas. Reg. § 1.72-11(f)(1).

Moreover, under Treas. Reg. § 1.72-11(f), a portion of the lump sum payment also is excluded from gross income:

> There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from the gross income of the recipient . . . as . . . the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract . . . .

Treas. Reg. § 1.72-11(f)(2)(i). See also Treas. Reg. § 1.72-11(f)(2)(ii); PLR 9025075. Thus, it will be necessary for the System to calculate an exclusion ratio with respect to the lump sum payment. The calculation will not, however, require the System to consult the life expectancy tables. Rather, the System should calculate a ratio determined by dividing the amount of the annuity reduction (in our case, the amount of the periodic DROP payment) by the amount of the original annuity payment (the combined regular retirement and periodic DROP payment). The participant's investment in the contract, as reduced by all previously excludable amounts, is then multiplied by this ratio to arrive at the tax-free portion of the lump sum payment.

IRS Publication 721, Tax Guide to U. S. Civil Service Retirement Benefits ("Tax Guide"), provides an example of how the above described calculation should be made. See Tax Guide at pp.

7 & 8 (attached). In the example, a Federal retiree is eligible to receive a life annuity of $1,000 per month, or a life annuity of $915 per month and a lump sum payment of $22,000. Her investment in the contract is $21,780. As the example demonstrates, a ratio of .085 is determined by dividing the amount of the annuity reduction ($85) by the amount of the original annuity payment ($1,000). The tax-free portion of the lump sum payment is then determined by multiplying the investment in the contract ($21,780) times .085, resulting in an excludable amount of $1,851.30.[11/]

11/ It is important to note that the Federal retiree had not previously excluded any annuity amounts from income. In our case, the participants will usually have received several annuity payments, a portion of which will have been excluded from income. The investment in the contract determined for purposes of calculating the lump sum excludable amount must be reduced to reflect any excludable amounts recovered up to the date the participant converts the periodic DROP payment to a lump sum.

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THEODORE E. RHODES
(202) 429-6272

December 26, 1990

VIA FEDERAL EXPRESS

[redacted]

RE: Effect of Changes made by OBRA 1990 to DROP

Dear [redacted]:

Section 11332(a) of OBRA 1990 amends the Social Security Act by adding to the definition of covered employment the following:

> service in the employ of a State (other than the District of Columbia, Guam, or American Samoa), of any political subdivision thereof, or of any instrumentality of any one or more of the foregoing which is wholly-owned thereby, by an individual who is not a member of a retirement system of such State, political subdivision, or instrumentality[.]

OBRA 1990, Pub. L. No. 101-508, § 11332, 101 Stat. __, __, amending Section 210(a)(7) of the Social Security Act, as amended (emphasis added). Section 11332(b) makes the same change in FICA's definition of covered employment. OBRA 1990, Pub. L. No. 101-508, 11332, 101 Stat. __, __, amending Section 3121(b)(7) of the Internal Revenue Code of 1986, as amended. This change goes into effect on July 1, 1991. Section 11332(d), OBRA 1990.

Thus, in order to determine whether DROP participants will be required to contribute to Social Security, it is necessary to determine whether they will be considered "members" of the retirement system during their period of DROP participation.

The conferees pointed out in their report accompanying OBRA 1990 that "[i]n some cases in which States have elected not to provide [Social Security] coverage, a part of the workforce does not participate in any public retirement plan." H.R. Rep. 964, 101st Cong., 2d Sess. 1103 (1990) (hereinafter H.R. Rep. 964). The statement implies that the provision's main purpose is to ensure that all State and local employees who are currently not covered by the applicable State and local pension plan will have retirement and disability protection through coverage under Social Security.

The legislative history generally provides that whether a plan participant will be considered a "member" for purposes of Social Security will depend upon whether that individual actually participates in the program:

> Thus, whether an employee participates is not determined by whether that individual holds a position that is included in a retirement system. Instead, that individual must actually be a member of the system. For example, an employee (whose job classification is of a type that ordinarily is entitled to coverage) is not a member of a retirement system if he or she is ineligible because of age or service conditions contained in the plan[1/] and, therefore, is required to be covered under social security. Similarly, if participation in the system is elective, and the employee elects not to participate, that employee does not participate in a system for purposes of this rule, and is to be covered under the social security system.

H.R. Rep. 964 at 1105.

On its face, the legislation enacting the DROP program deems an individual's membership in [redacted] to cease during his period of participation in DROP. *See, e.g.*, DROP [redacted]

1/ Although employees who enter state service at age 60 or over are not eligible for [redacted] membership [redacted] (hereinafter [redacted]), there are no minimum age or service requirements for membership. Under Section 11332, the age 60-plus group would have to be covered by Social Security. We did discuss, however, that the maximum age restriction presents a problem under the ADEA.

However, because DROP is clearly a part of the System, it appears that a DROP participant continues to be a member of [redacted] even though no contributions are made on his or her behalf during that time.[2]

This does not end the inquiry, however. The legislative history also provides:

> Except as otherwise provided under the conference agreement, or in guidance promulgated by the Secretary of the Treasury, rules similar to those applicable in determining whether an individual is an active participant for purposes of contributing to an individual retirement account (Code sec. 219) apply in determining whether a specific employee is a member of a retirement system.

H.R. Rep. 964 at 1105. Thus, if an individual would be considered an "active participant" under Code section 219, he or she would be a "member" of a retirement system, and, therefore, need not be covered by Social Security. Applying the standards developed under Code section 219, it is our view that DROP participants need not be covered by Social Security.

Code section 219 defines the term "active participant" somewhat circularly as an individual who is an active participant in one of several enumerated types of retirement plans, including a plan established by a state or political subdivision thereof. I.R.C § 219(g)(5)(A)(iii). As a result, an examination of the regulations, legislative history, and other relevant materials is necessary.

The regulations under Code section 219, like the legislative history to OBRA, provide that:

> an individual is not an active participant under a plan for any taxable year of such individual for which such individual elects, pursuant to the plan, not to participate in such plan.

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[2] Although most employees must join the System, Section 551(1) makes an exception for those "to whom an option or election is provided." We understand that this language does not cover those who elect to participate in DROP.

Treas. Reg. § 1.219-2(f). Although as currently drafted the DROP statute states that an individual who elects to participate in DROP ceases to be a member of [redacted], DROP is a part of the System and therefore DROP membership should constitute participation in a retirement plan.

In addition, the regulations and related guidance under Code section 219 specify that an individual in a defined benefit plan who accrues no benefit after attaining a specified age is not an active participant. Treas. Reg. § 1.219-2(b)(4); PLR 8011075 (Dec. 20, 1979).[3] In PLR 8107057 (Nov. 19, 1980), the Internal Revenue Service considered a situation involving a defined benefit plan that froze benefits at normal retirement age. Under the plan, employees who worked beyond normal retirement age had credited to a "late retirement account" the actuarial value of the benefits to which they would have been entitled had they retired at normal retirement age, plus interest. The Service ruled, pursuant to Treas. Reg. § 1.219-2(b)(4), that such individuals were not active participants after attaining normal retirement age.[4]

The DROP program is readily distinguishable from the situation considered in PLR 8107057. First, participation in DROP is not based upon age alone. Rather, System participants who are one year beyond eligibility for regular retirement based upon their combined age and service may elect to participate in DROP. Second, participation in DROP does not result in the permanent cessation of benefit accruals. Rather, DROP participation represents a voluntary choice by participants to exchange up to two years of benefit accruals under the basic System for the advantages of the DROP program, including future benefit accruals.

More fundamentally, however, the policy reasons for concluding that participants who cease to accrue benefits at a specified age should be permitted to establish an IRA or contrib-

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[3] Moreover, the Service has ruled that where an individual's benefit is frozen at normal retirement age, a subsequent change in the plan increasing the amount of the fixed benefit does not render the individual an active participant for years after his normal retirement age. PLR 8118021 (Feb. 3, 1981); PLR 8014046 (Jan. 9, 1980).

[4] Likewise, the Service has concluded that a retired individual who is receiving pension payments is not an active participant. Notice 87-16, Q&A 8, 1987-1 C.B. 446, 448.

ute to the Social Security System, do not apply in the DROP context. Where a plan involuntarily ceases accruals based upon age, affected participants may have accrued only a minimal benefit under the plan. By contrast, DROP participants are by definition already entitled to a full unreduced regular retirement benefit from the System, and may, in fact, accrue additional benefits after their DROP participation ceases. Thus, Congress' interest in ensuring that all State employees receive retirement protection is not relevant with respect to DROP participants.

Indeed, the Service has recognized that in a number of situations, a plan participant may not receive an additional benefit and yet may still be considered an active participant. Thus, for example, in PLR 7946067 (Aug. 17, 1979), the Service concluded that Treas. Reg. § 1.219-2(b)(4) was irrelevant in a situation where an individual ceased to accrue additional benefits because he had already accrued the maximum monthly benefit under the plan. Instead, such a participant remained an active participant under Code section 219. See also PLR 8016094 (Jan. 24, 1980). DROP participants are in a comparable situation. The DROP program simply provides one set of rules regarding maximum accruals under the System. See also Notice 87-16, Q&A 14-15 (individual is active participant even if individual has no vested interest in accrual or fails to complete requisite number of hours of service to accrue a benefit in a year).

Moreover, in Notice 87-16, the Service concluded that an individual who accrues a benefit of only one dollar for a plan year is an active participant. Notice 87-16, Q&A 13, 1987-1 C.B. at 448. If that is the case, then there is no principled basis for reaching a contrary result with respect to DROP participants. Individuals will obviously elect to participate in DROP only if they see themselves as gaining something by the choice. Requiring, in addition, a nominal accrual during DROP participation, would appear to serve no useful purpose.[5]

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[5] At present, interest is not credited to a participant's DROP account during his/her participation. DROP [redacted] Allowing DROP participants to earn interest would not in itself resolve the issue at hand, however. In PLR 8207064 (Nov. 19, 1981), the IRS ruled that although interest continues to accrue on a participant's balance, this does not cause an employee to be considered an active participant in the plan. The IRS explained that interest is "neither a forfeiture nor an employee contribution to the employee's account." Id.

After you have reviewed this letter, please call if you have any questions.

Sincerely,

Ted Rhodes

Theodore Rhodes

Enclosures